Audit Quality on Earnings Management: Evidence from Sri Lankan Listed Companies

JANARTHAN, M.*

Department of Finance and Accountancy, Faculty of Business Studies
University of Vavuniya.

THEVARUBAN, J.S.

Department of Finance and Accountancy, Faculty of Business Studies,
University of Vavuniya.

Abstract

The quality of an audit is one of the influential factors in the improvement of financial transparency and the assurance of stakeholders in corporate reporting. It shows the capability of the auditor to identify and disclose material misstatements, which enhances the credibility of the financial statements. The notion has changed to compliance but focused on ethical integrity, independence of the auditor and professional skepticism as elements of audit effectiveness. The quality of audits helps to alleviate agency costs as they verify the accuracy of management disclosures without favoritism, thus decreasing information asymmetry between the shareholders and the management. Recent research has also linked audit quality to firm-specific variables including tenure, transparency of the audit firm, and low governance structure of the audit firm. The audit practices have been redesigned through the regulatory framework and technological innovations, such as data analytics, which enhance the effectiveness and precision of the audit procedure. Also, the COVID-19 brought additional pressure to a conventional form of auditing, enhancing the transition towards remote and technology-supported auditing, which affected attitudes to audit quality. Essentially, audit quality is a complex entity that is determined by ethical standards, competence of the auditor, regulatory influence, and integration of technology. The audit quality should be maintained in order to preserve the trust of the investors, maintain compliance, and lend credit to the capital markets.

Keywords: Audit quality, audit size, earnings management, firm size

Introduction

Earnings form one of the major indications of the financial performance of an organization and form a central theme of financial reporting (Pakianathan, 2017). The subject of earnings management (EM) has gained great importance in the study of accounting because of the ethical implication it carries and its association with some of the biggest corporate scandals like Enron (Perera and Amarasinghe, 2022). Enron downfall is a famous case of accounting fraud, and it

serves as an example of the high level of danger of EM. Earnings manipulation is a common activity among organizations that are new in the market or experiencing financial strain appears to be performing well at the expense of credibility in the financial information that is given to stakeholders (Withana and Ajward, 2022).

Auditors are supposed to be autonomous guardians of the financial reporting whereby the reported earnings are not manipulated and material misstatements are duly detected. In this capacity, auditors enable investors to have more confidence and also encourage stability of the market through maintaining credibility of financial disclosures. Legally required statutory audits oblige auditors to give an objective view to whether or not financial statements reflect a fair view of an organization's financial position.

The arguments in favor of external auditing are based on the agency theory, which reveals the existence of a conflict inherent in the separation of ownership and control. Information asymmetry aggravates this conflict because managers are in a better position to know more about the financial operations of the firm than the shareholders and thus tend to engage in EM behaviors since shareholders have a weak ability to check the actions of managers (Alzoubi, 2021). The most noticeable global example is the 2009 Satyam scandal in India, in which its managers artificial inflated revenues through fabricated invoices, which demonstrates that EM goes across the frontiers and sectors (Pakianathan, 2017). Such incidences show that EM compromises integrity of audited financial statements and loses investor confidence.

According to previous research, a significant portion of the corporate failures can be linked to inadequate audit control, and close to 70 percent of failed corporations have obtained unqualified audit opinions before collapsing (Taqi, 2020). The Enron-Arthur Andersen case reiterated the global significance of audit quality in high regard of the people to the financial reporting. Corporate collapses in Sri Lanka like the Pramuka Bank, the Golden key PLC, and Touchwood Investments are also good examples of how poor audit quality and financial reporting contributes to financial misconduct (Pakianathan et al., 2019).

Despite the fact that the audit role is created as a control device to limit the agency problems, there are still concerns about the quality and reliability of audit. The evidence on whether higher quality of audit effectively limits EM after international research has yielded mixed results according to markets and regulatory environment. Nevertheless, empirical research in Sri Lanka is limited and isolated, and it is evident that there is a gap in the research on how audit quality affects EM in the dynamic corporate environment in the country. The proposed paper fills this gap by presenting recent empirical data of listed companies in Sri Lanka and making contributions to a global debate that has not yet been fully resolved.

The primary aim of this study is to conduct research that focuses on determining the role of audit quality on earnings management in publicly listed companies in Sri Lanka. Particularly, it

researches the impacts of audit tenure, the size of an audit firm, and auditor independence on the extent of earnings management. The research revolves around the non-financial companies listed in Colombo Stock Exchange (CSE) and discretionary accruals through modified Jones Model as a measure of EM. The data includes 50 listed companies during the 2019-2023 years, the analysis will use descriptive statistics, correlation tests, and regression. The credibility of external auditing has been brought into question the world over and locally due to the recurrent financial scandals. The fact that the EM practices remain a reality in both developed and emerging markets still casts doubt on the issue of transparency, protection of investors, and the integrity of financial reporting systems.

Literature Review

Concept of Earning Management

Earnings management (EM) is a management action in which the management intervenes in the financial reporting with a fixed purpose of attaining a personal or organizational objective (Bachtijeva & Tamuleviciene, 2022). In line with the classical definition by Schipper, EM refers to managerial judgment in financial statements and the structure of the transactions that can mislead the stakeholders or affect the contractual results (Christensen et al., 2022). This definition recognizes two prevailing types, which are the accrual-based earnings management (AEM) and real earnings management (REM). The first one is the manipulation of the accounting estimates, and the second one of the manipulations of the real business processes, production or discretionary spending (Bansal, 2024).

The literature highlights that main causes of EM are the pressure of capital markets, incentives of managerial compensation, and contractual commitments (Habib et al., 2022; Gokhale and Pillai, 2024). Companies are more likely to undertake EM when there is uncertainty or macroeconomic instability, especially in sectors which are vulnerable to global shocks such as commodities (Springer, 2024). Although there are short-term benefits, EM has negative long-term effects, such as the loss of credibility of the financial statements, misinformation of investors, and the decline of the firm value (Bansal, 2024). Moreover, the increasing role of environmental, social, and governance (ESG) reporting has demonstrated a twofold implication as it may limit EM by becoming more transparent, or it may be more opportunistic (Bansal, 2024).

In comparison to AEM, in REM, normal operations, investment, or financing activities are changed to manipulate reported results (Sitanggang et al., 2019). Pakianathan (2017) has indicated that compared to AEM, which acts through accounting adjustments, REM has direct influence on cash flows. Discretion of financial reporting systems facilitates manipulations on account of subjective estimates of assets in terms of life, impairments, depreciation and valuation techniques. Kustono et al. (2021) discovered that listed companies in Sri Lanka often manipulate the depreciation and tax provisions. Such activities may be useful in ensuring that forecasts of the analysts are achieved

or the firm keeps its covenants, but they undermine the firm's performance in the long term (Christensen et al., 2022).

Accrual-based EM is usually evaluated by identifying discretionary accruals, which are accruals caused by the manipulation of managers, and non-discretionary accruals, the outcomes of ordinary business activities (Saleh et al., 2007; Pakianathan, 2017). The most popular estimation models are Healy, DeAngelo, Jones, and Industry models. The Modified Jones Model is the most utilized one because it is more effective to distinguish discretionary accruals (Almahrog & Lasyoud, 2021). It is however imperative to mention that these models are basically only representatives as equivalents and do not observe the intent of the manager. Because auditing is meant to identify anomalies, the association between audit quality (AQ) and EM has been the center of interest in the accounting study (Pakianathan et al., 2019). However, there are still the challenges since the quality of audits is multidimensional and its proxies, including auditor size, tenure, or fees, are proxy measures (Dechow et al., 2010).

Concept of Audit Quality

Audit quality (AQ) is the ability of an auditor to provide the appropriate financial assurance in a transparent, objective, and precise manner (Francis, 2023). It is a multidimensional construct which includes auditor competence, independence, professional skepticism and reporting transparency. New frameworks emphasize that AQ is to be measured in terms of input indicators (i.e., auditor size and tenure), process-related indicators (i.e., skepticism and workload), and output-related indicators (i.e., restatements or investor confidence) (Alhababsah & Yekini, 2021). The establishment of Key Audit Matters (KAMs) has contributed to the increase of audit transparency and understanding by the stakeholders. Nonetheless, empirical findings indicate that KAM disclosures are more effective in institutional settings than in others (Elmarzouky et al., 2023). The behavioral factors including the competence of the team, time pressure, and stress are also vital and determine the effectiveness of the audit (Samagaio et al., 2023). Auditing gives the financial reports credibility, as they are the real and fair reflection of the performance of a company (Caruana & Kowalczyk, 2021). It was observed that the quality of the audit is determined by the capacity to detect and independence of auditors (Pontoh and Yolanda, 2021). The perceived independence and reputation are important because the users of financial statements do not have direct observation of the audit processes (Pakianathan, 2017).

Bradshaw et al. (2001) proposed that a high audit quality means that the auditors are eager and capable of reporting material misrepresentations even to the detriment of the relationship with their clients. Based on this, the auditor can perform the assessment of AQ based on his/her professionalism and technical competence (Pakianathan, 2017). The traditional proxies of AQ are the auditor size (Big 4 or non-Big 4) and auditors fees, which still have controversy when it comes to their interpretation. Although an increase in fees can indicate an increase in audit effort, they can also indicate economic dependence, which is contrary to independence (Pakianathan, 2017).

After high-profile scandals like Enron and WorldCom, the scope of definitions of AQ changed to include the requirement to adhere to Generally Accepted Auditing Standards (GAAS) and to be certain that financial statements are prepared in compliance with Generally Accepted Accounting Principles (GAAP) (Alhadab, 2018). High-quality audits, as indicated by the U.S. Government Accountability Office (2003) are also those that do not have any material misstatement whether caused by fraud or error. The external auditors consequently have a crucial role in the monitoring process to guarantee justifiable presentation of the company performance (Alzoubi, 2016). As such, an increase in AQ will likely restrict opportunistic EM and enhance financial reporting.

Theoretical Relation between Audit quality and earnings management

The nature of the association between AQ and EM is based on the Agency Theory that assumes that audits alleviate the conflicts of interests between the principal (shareholders) and the agents (managers) through minimizing information asymmetry (Pakianathan et al., 2019; Alzoubi, 2016). Audits are a restrictive mechanism of managerial discretion and enhance transparency, which is why they are essential elements of governance through independent verification. Thus, it is conceptually assumed that, the quality of the audit will have a negative relationship with earnings manipulation (Alzoubi, 2016).

Empirical Evidence on Relation between Quality of Auditing and Earnings Management

There is no clear empirical evidence regarding the relationship between AQ and EM. Although high-quality auditing is theoretically expected to restrict EM by enhancing monitoring processes, the outcomes are different across situations because of differences in regulation, methodology, and firm specifics (Pakianathan et al., 2019). Research into auditor tenure gives contradictory results. Hohenfels (2016) concluded that the EM diminishes in the U.S. firms with the length of the auditor tenure, but Patterson et al. (2019) and Cassell (2020) concluded that longer relationships can hinder independence. Similar mixed evidence exists in regional studies Weerapong (2014) conducted a study and discovered that in Southeast Asia tenure was a lower predictor of AQ, whereas Cheong et al. (2015) found no significant relationship in Malaysia. Similarly, there has been conflicting evidence on audit firm size research. Al-Khaddash et al. (2013); Habbash & Alghamdi (2017) concluded that larger companies offer better quality of audits because of reputational risks, whereas Alves (2013) also found that Big Four firms may use EM in retaining clients. Rusmin (2010) and later research on the other hand found out that the level of EM in Big Four auditors is usually lower than that of small auditors.

Another important determinant is audit independence. Tepalagul & Lin (2015) established client importance, non-audit services, and tenure as one of the threats to independence. Alhadab (2018) discovered that increased audit and non-audit fees were associated with increased earnings restatements, which are indicators of decreased independence. Nevertheless, Alzoubi (2016) found a contrary situation in Jordanian companies- increased audit fees were associated with reduced EM, which implies increased audit. Likewise, Cho & Kwon (2017) have found that higher fees

were related to high-quality accruals and Ching et al. (2015) did not establish any significant dependence in Malaysia. Another piece of evidence found in Sri Lanka suggests that there is a weak correlation between AQ and EM, which underlines that more robust audit guidelines are required to discourage opportunistic reporting (Pakianathan et al., 2019).

Research Gap

Altogether, the literature confirms that EM and AQ are multidimensional and complex concepts due to incentives, regulations and market conditions. The hypothetical background including, but not limited to, Agency Theory and application of the Modified Jones Model are typical to auditing studies. Nonetheless, previous research indicates conflicting empirical evidence on the AQ-EM relationship, which is mainly attributable to the difference in measurement proxies, economies, and governance systems. Therefore, the gap in the research is the insufficient context-specific information on how the quality of audit affects the earnings management in emerging economies like Sri Lanka in which institutional and regulatory frameworks are very different as compared with developed markets. This study, therefore, seeks to fill this gap by analyzing the empirical relationship between quality of audit and earnings management in the context of the Sri Lankan situation.

Methodology

Data and Sample

This study examines how the quality of audit impacts the earnings management of CSE-listed companies. By 31 December 2025, the CSE had 285 companies in 20 Global Industry Classification Standard (GICS)-based sectors. In the context of this research, 50 industries were taken into consideration, namely, the ones whose financial year ended on 31 March. The analysis spans a recent five-year period, between 2019/20 and 2023/24 based on the analysis of the audit reports of the selected companies. The sample is the final one, comprising of 50 listed firms monitored in five consecutive years, which provide 250 firm-year observations. The selection criteria used were:

- Omission of financial institutions including banks, insurances and diversified financial companies. These have not been taken because of regulatory differences and variation in reporting practices, profitability and liquidity ratios and are not so comparable to non-financial sectors.
- Consistency in reporting periods by inclusion of companies whose financial year ends in March.
- It will be continuous over the course of the study and all five years will have full access to financial information.

By December 2019, these requirements were met by 50 companies in 20 industry groups. Newly listed firms, those with financial years ending in December, as well as those that did not have

adequate data to compute the variables needed were not considered. The end product was a sample of 50 firms that were fit to be studied. The research is based solely on secondary sources, i.e. the published annual reports of companies used in the study which are on the CSE site. The most critical parts of the reports that were analyzed are the Statement of Profit or Loss and Other Comprehensive Income, Statement of Financial Position, Notes to the Financial Statements, the Independent Auditor Report, and disclosures that involve the Audit Committee.
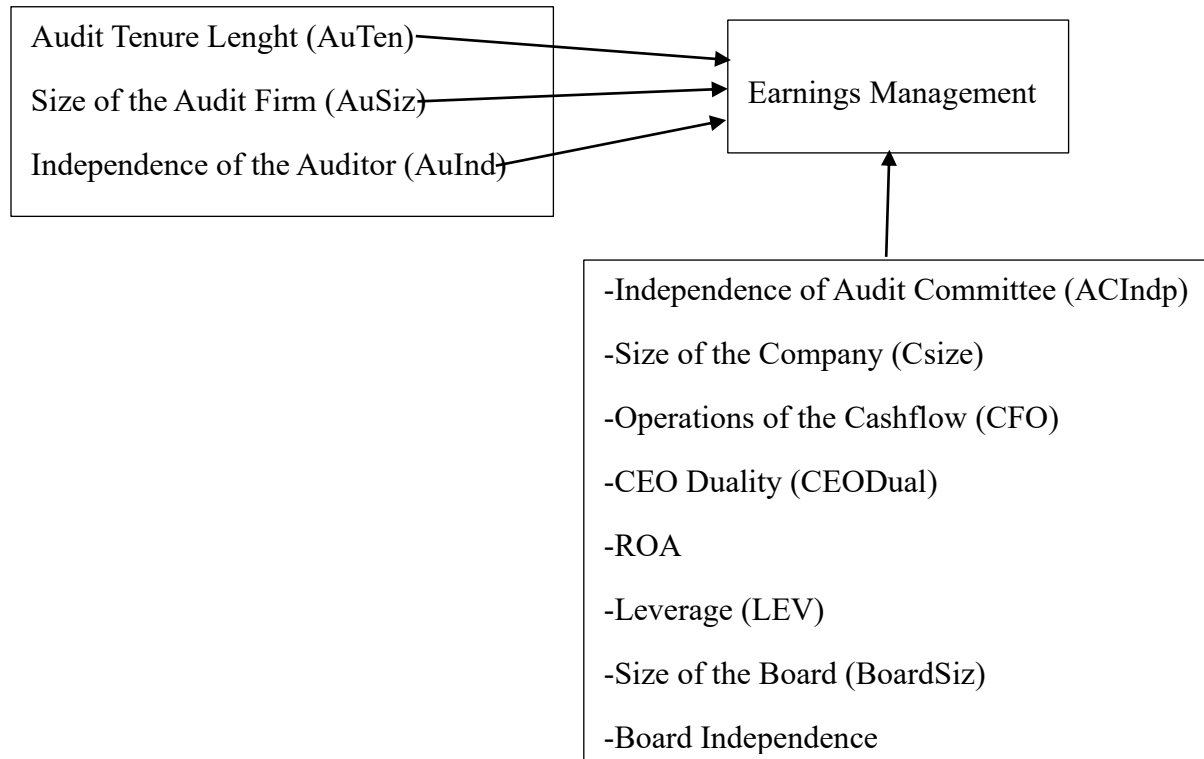
Conceptual Framework

Figure 1: Conceptual Framework

The following hypotheses are formulated in this study.

H1: Length of the Audit tenure has significantly impact on the Earning management

H0: Length of the Audit tenure has not significantly impact on the earning management

H2: Audit firm size has significantly impact on the earning management

H0: Audit firm size has not significantly impact on the earnings Management

H3: Auditor Independence has significantly impact on the earnings management

H0: Auditor independence has not significantly impact on the earnings management

Measurement of Variables

Independent Variables

Audit Tenure Length (AuTen) is measured as a dummy variable allocating 1 when the tenure as an auditor is above 3 years, 0 for the tenure below 3 years (Xiao and Zhou, 1999). Size of the Audit Firm (AuSiz) is determined based on previous literature (Pakianathan et al., 2019) as a dummy variable, representing 1 in case the company was audited by one of the big four (i.e. KPMG, Ernst & Young, PricewaterhouseCoopers, and Deloitte) in the four-year period and 0 otherwise. Independence of the Auditor (AuInd) is determined as the natural logarithm of audit fees as an alternative proxy to available literature (Alzoubi, 2021).

Dependent Variable

In this study, the measurement of earnings management is done through discretionary accruals. The most popular method of accrual analysis is the modified Jones model (Alzoubi, 2016). The original Jones Model uses the change in total accruals by regressing it on the change in revenue and the gross property, plant, and equipment. It captures the working capital accruals as a factor of the revenue growth and depreciation as a factor of gross property, plant and equipment. There are two methods for calculating total accruals. These are the cash flow and balance sheet methodologies. By disrupting the discretionary accruals computations, the balance sheet approach may result in Type I errors, whereby the study may conclude that earnings management has occurred when it has not (Pakianathan, 2017). Therefore, the cash flow statement methodology is used in this study to calculate total accruals.

$$TACC_{it} = NI_{it} - CFO_{it}$$

Where: TACC-Total accruals

NI-Net Income

CFO-net cashflow from operations

$$TACC_{it} = \beta1(1TA_{it-1}) + \beta2(\Delta REV_{it} - \Delta REC_{it}) + \beta3(PPE_{it}) + \iota_{it}$$

$TACC_{it}$ = The total accruals

TA_{it-1} = The total assets of firm

ΔREV_{it} = The change in revenues of firm

ΔREC_{it} = The change in receivables of firm

PPE_{it} = The level of fixed assets of firm

ι_{it} = Random error

$$TACC_{it}/A_{it-1} = \alpha + \beta1(1/A_{it-1}) + \beta2(\Delta REV_{it} - \Delta REC_{it}/A_{it-1}) + \beta3(PPE_{it}/A_{it-1}) + \iota_{it}$$

Discretionary Accruals is calculated as follows.

$$DACC_{it} = TACC_{it} - NDAC_{it}$$

Control Variables

The research has a number of control variables; they are Audit Committee Independence, Company Size, Leverage, Cash Flows of Operation, Return on Assets (ROA), Board Size, CEO Duality, Board Independence, Industry Category. One of the most common opinions is that the higher the independence of the audit committee, the higher the effectiveness of oversight and, thus, the better the quality of the reported earnings (Pakianathan, 2017). A negative correlation between audit committee independence and earnings management (EM), as well as a strong negative association, was also found by Alzoubi (2021). The variable, in this case, is an appointment of independent non-executive directors on each committee.

One of the most commonly used control variables of past studies is company size (Alzoubi, 2016; Pakianathan et al., 2019). Larger companies have greater risks of litigation and scrutiny of investors in comparison to smaller ones (Pakianathan, 2017). In this respect the natural logarithm of total assets is used to quantify the size of the company. Another factor that is worth keeping in mind is leverage, where companies can take advantage of EM to not violate debt covenants (Pakianathan et al., 2019). The likelihood of default also increases with highly leveraged companies resorting to income-increasing accrual, although the high indebtedness may limit EM because the lenders monitor them. The past literature indicates that leverage and EM have a positive association (Alzoubi, 2021). The leverage in this analysis is determined by dividing total debt by total assets in the start of the year.

EM behavior is also affected by cash flow stability. Companies that have high operating cash flows are less likely to engage in earnings management because their profitability is sustainable and identified a negative relationship between cash flow and operations and discretionary accruals. This paper directly quantifies cash flow with the amount on the cash flow statement of companies. As a control, ROA, a measure of how well the management is able to generate returns on assets is provided because companies can play around with earnings to prevent losses or deteriorating performance. Since financial performance may motivate discretionary accruals, ROA is obtained as the net income/average total assets.

Board size may have two contrary effects on EM. According to the agency theory, bigger boards can create a conflict of interest and allow managers to use discretion to benefit themselves (Alzoubi, 2021). On the other hand, the greater the size of the boards, the more expertise may be offered, which enhances monitoring and restricts EM (Alzoubi, 2016). In this paper, the total number of board members is taken as the measure, and an optimal size of 7-8 directors is taken as the most effective. Duality between the CEO and the Chairman of the Board, or between a single individual in the role of CEO and the role of Chairman, might compromise internal controls and make EM easier. Separating the roles (theoretically) should decrease EM (Pakianathan, 2017), yet previous research indicates that there is no reliable relationship (Lin and Hwang, 2010). In this

case, CEO duality will be quantified as a nominal variable, with a nominal data of 1 when roles are combined, and 0 when roles are separated.

The independence of the board is also evaluated, and independent directors should improve the effectiveness of the monitoring (Alzoubi, 2021). Whereas discovered a negative relationship with EM, Alzoubi (2021) has suggested that independence is not necessarily effective control. The number of independent non-executive directors on the board is used as a measure of this variable.Lastly, the industry impact is mitigated, since sector specific variables can give biased outcomes. To circumvent clustering effects on EM, industry category is measured by 15 dummy variables (Pakianathan et al., 2019).

Data Analyzing Method

In analyzing the data, this paper will use descriptive statistics, correlation test and multivariate regression to determine the impact of audit quality in the management of earnings. The descriptive statistics are employed to describe the features of the sample and it gives measures such as the mean, median, standard deviation, minimum, maximum, skewness and kurtosis of the individual variables. Pearson correlation is used to examine pair-wise relationships, establish how strong, positive, and significant relationships are and test the possibility of multicollinearity among variables. In order to test the hypotheses, the study will use a Pooled Ordinary Least Squares (OLS) regression model. This method appraises the relationship direction by estimating the coefficient and determining the significance of such estimates by the p-values. The regression model that was used in the analysis is below:

$$DACCit = \beta0 + \beta1AuTeni,t + \beta2AuSizit + \beta3AuIndit + \beta4ACIndit + \beta5CSizit + \beta6Levit - 1 + \beta7CFOit + \beta8ROAit + \beta9BoardSizit + \beta10CEODualit + \beta11BoardIndit + \varepsilon i,t$$

Results and Discussion

This section is mainly providing the findings and discussion by the analysis of descriptive analysis, correlation analysis and regression model.

Descriptive Statistics

Table 1 illustrates the summary of the most important variables to be utilized in the research, considering 250 observations of firm-years in Sri Lankan listed firms of the period between 2019 and 2023. It assists in outlining the most recent trends (mean), variation (standard deviation), and scope (minimum and maximum values) of the data. Beginning with the variables in the audit, Audit Tenure (AuTen) has a mean of 0.66 which implies that 66.0 percent of the sample firms had multiple years of auditor engagement and 34.0 percent of the sample firms had shorter time of auditor engagement. The variation in the standard deviation (0.47) is moderate in firms. The mean of Audit Firm Size (AuSize) stands at 0.52 implying that a little above half of the sample companies were audited by bigger firms (more probably Big 4 affiliates) with the rest using smaller local

firms. The mean of Audit Independence (AuInd) is 14.36 (the range of the variable is 13.12-15.67), which means that auditors have rather high level of independence, but variability is low (SD = 0.60). On the dependent variable, Discretionary Accruals (DAC) which is a proxy of earnings management, the mean of this is 0.1784 which demonstrates that on average 17.84 percent of all accruals are discretionary. The standard deviation (0.04) is relatively low, indicating that there is moderately consistent level of earnings manipulation among the firms.

The Audit Committee Independence (ACInd) is one of the indicators in the field of corporate governance with the mean of 4.50 and the range of 3 to 6 as a sign of relatively independent audit committees. The average board size is 8.5 with a minimum of 6 and a maximum of 11 board members in the firm boards, which are not highly diverse in the selection of boards. The mean of CEO Duality (CEODual) is 0.32 and this implies that 32 percent of the firms have a combination of CEO and board chair roles whereas 68 percent have separated the two positions. Board Independence (BoardInd) has a mean of 4.14, with a range of between 2 and 7 independent directors, which implies that majority of firms have a number of independent directors but have a different governance structure.

Table 01: Descriptive Statistics

	Minimum	Maximum	Mean	Std. Deviation
AuTen	.00	1.00	.6600	.47466
AuSize	.00	1.00	.5240	.50043
AuInd	13.12	15.67	14.3623	.59550
DAC	.09	.27	.1784	.04090
ACInd	3.00	6.00	4.5040	1.03841
SizeInAssets	15.67	20.78	18.2483	1.12273
Leverage	.36	.75	.5331	.08553
CFO	19876.54	45234.67	32403.8747	6117.14392
ROA	.02	.23	.1305	.04654
BoardSize	6.00	11.00	8.5000	1.74993
CEODual	.00	1.00	.3200	.46741
BoardInd	2.00	7.00	4.1360	1.60993

As an example of a firm-level control variable, Firm Size (SizeInAssets) has a mean log of 18.25 with a range of 15.67 to 20.78 indicating a sample of small, medium, and large firms in the dataset. The value of leverage is 0.53, which implies that on average debt is approximately 53 percent of total assets- a factor which shows that Sri Lankan listed companies have an average of moderate financial leverage. The variation in Cash Flow from Operation (CFO) is also significant because the values fluctuated between 19,874.54 and 45,234.67 and the mean is rather high (32,403.87) and indicates that there is a wide difference in the liquidity and operational cash performance of firms. The mean of Return on Assets (ROA) is 0.13, which shows that on average, companies achieve a 13-percentage point of their total assets, but the variation is moderate (SD = 0.0465).

To conclude, the descriptive statistics show that the majority of firms in the sample have moderate audit quality traits, moderate level of earnings management, and balanced corporate governance structures. The financial indicators (leverage, ROA, CFO) show a high level of variation, which implies that the firms show different performance and financial situations within the sample. Such descriptive patterns give a preliminary explanation of the dataset before correlation and regression analyses can proceed to the next level.

Regression Analysis

The multiple regression model proved to fit very well with a correlation coefficient (R) of 0.974 and an R-squared measure of 0.949 as indicated in the model summary. This implies that it is the aggregate effect of the independent variables that explains earnings management (DAC) variance by about 94.9. The adjusted R-squared of 0.947 affirms that, even after the number of predictors were factored in, the model still has a strong explanatory power. The standard error of the estimate (0.00944) is also an indication that the prediction errors or residues are small hence high reliability of the model. The findings represent that the combination of the chosen proxies of audit quality, corporate governance, and firm characteristics offers a very high level of explanations of the variations in discretionary accruals in the Sri Lankan listed firms. This justifies the assumption that the quality of the audit and the qualities of corporate governance are both influential in an attempt to mitigate the opportunistic practices of earnings management (Alzoubi, 2021).

Table 02: Regression Coefficients Analysis

	Unstandardized Coefficients		t-stat	p-value
	B	Std. Error		
Constant	0.209	.024	8.699	0.000
AuTen	-0.001	.001	-0.825	0.410
AuSize	0.000	.001	-0.143	0.886
AuInd	-0.007	.002	-3.799	0.000
ACInd	-0.001	.001	-1.890	0.060
SizeInAssets	-0.006	.001	-5.042	0.000
Leverage	0.110	.017	6.582	0.000
CFO	0.000	.000	13.164	0.000
ROA	0.495	.029	17.001	0.000
BoardSize	0.000	.000	-0.290	0.772
CEODual	-0.015	.002	-9.533	0.000
BoardInd	-0.004	.000	-7.490	0.000
	R=0.974	R^2=0.949	Adj R^2=0.947	Std error=0.009
		F stat = 402.946 (p-value 0.000)		

The Analysis of Variance (ANOVA) shows that the regression model is statistically significant with the F-statistics of 402.946 and the p-value of 0.000. This means that the entire model has a considerable predictive power on the dependent variable (earnings management). The level of significance is very low, below 0.01, and it means that the probability of this strong correlation to happen randomly is insignificant. Thus, the findings affirm that one of the independent variables at least makes significant contributions towards explaining the differences in earnings management among Sri Lankan listed companies. This confirms the usefulness of the model in investigating the effects of the audit quality dimensions and governance factors on discretionary accruals.

The regression coefficients will provide an idea of the personal contribution and orientation of each of the predictor variables on earnings management. The findings are summarized and discussed as follows:

Audit Tenure (AuTen): The coefficient (-0.001, p = 0.410) is statistically meaningless, therefore, it means that the audit tenure is not significant in earnings management. This implies that the duration of the auditor-client relationship will not necessarily result into less or more earnings manipulation. These results can be typical of the Sri Lankan business context, where the audit rotation obligatory and regulatory controls prevent the possible adverse impact of the long-term auditor relationships (Withana and Ajward, 2022).

Audit Firm Size (AuSize): The coefficient (0.000, p = 0.886) was again insignificant and thus this means that the size or reputation of the audit firm does not directly influence the degree of the earnings management. Although bigger companies can be viewed as offering better quality audits, this result states that the size of a firm is not the only factor that might guarantee increased audit performance (Perera and Amarasinghe, 2022).

Audit Independence (AuInd): The coefficient (-0.007, p = 0.000) indicates a negative relationship but this is significant which implies that as the auditor independence increases, the earnings management decreases. It complies with the essence of the auditor independence as the means of providing protection against bias and raising the level of financial reporting reliability (Pakianathan, 2017).

Audit Committee Independence (ACInd): The coefficient (-0.001, p = 0.060) is slightly significant, indicating that the more independent the audit committee, the smaller chances there are that the earnings are going to be manipulated. This helps to argue that the external audit role might be enhanced with the help of governance mechanisms, like independent oversight committees (Alzoubi, 2021).

Firm Size (SizeInAssets): The value (-0.006, p = 0.000) suggests that there is a substantial negative correlation between the firm size and the earnings management. The bigger companies that are usually scrutinized more and have stricter disclosure policies are less likely to participate in the opportunistic adjustments of earnings.

Leverage: The coefficient (0.110, p = 0.000) indicates that the relationship between debt ratios and earnings management is rather strong, i.e. companies that are more indebted have more probability of earnings management. This helps to explain that creditors can use financial pressure to encourage managers to engage in manipulating reported earnings to fulfill debt covenants, or to indicate financial health (Taqi, 2020).

Cash Flow from Operations (CFO): The coefficient (2.635E-06, p=0.000) is positive and significant and implies that companies that have higher operating cash flows are related to higher discretionary accruals. This can be used to imply that operating cash flow performance is one of the justifications that companies use to smooth or manipulate reported earnings.

Return on Assets (ROA): The coefficient (0.495, p = 0.000) is positive and significant and indicates that companies with greater profits are more likely to carry out greater earnings management. This might indicate incentives on the part of management to uphold or improve on the perceived trends of profitability to the market reputation (Pakianathan, 2017).

Board Size: The coefficient (0.000, p = 0.772) is insignificant, and it can be assumed that the size of the board does not have a significant effect on the level of earnings management. The size of the board of directors cannot necessarily ensure that it will exercise proper oversight in the case of a board that is not independent or lacking in skills.

CEO Duality (CEO Dual): The coefficient (-0.015, p = 0.000) shows that the effect is negative (significant), i.e., in the case the CEO is also a chairperson of the board, the earnings management is lower. This finding is contrary to the expectations in agency theory but can indicate local governance relationships in the Sri Lankan companies, where dual leadership can make accountability simpler (Withana & Ajward, 2022).

Board Independence (BoardInd): (-0.004, 0.000) indicates that the relationship is strong, with the higher the percentage of independent directors, the lower the earnings management. This observation is consistent with the theory of corporate governance, as independent control reduces the opportunism in managers (Alzoubi, 2021).

Correlation Analysis

The analysis of the correlation shows that there are quite a number of important discoveries that look into the connections among audit features, the company-level variables, and discretionary accruals (DAC), which are earnings management.

To begin with, there is a significant positive and statistical correlation between auditor independence (AuInd) and DAC (r = 0.579, p < 0.01). This conclusion comes out as counter intuitive in the sense that greater independence of auditors is supposed to decrease earnings manipulation. Nevertheless, the relationship could be reversed and the companies who undertake

more earnings management have more independent auditors to communicate legitimacy and augment external credibility. Alternatively, in the Sri Lankan case, formal independence may not imply substantive audit quality i.e. independence exists in form but not necessarily in operations in limiting managerial opportunism.

Audit tenure (AuTen) on the other hand, has a very weak and statistically insignificant connection with DAC ($r = 0.031$, $p = 0.626$), which means that the duration of auditor-client relationship does not have significant effect on earnings management. This could be explained by the equal impacts of continuity and familiarity on the one hand, long-term auditors provide audit efficiency but on the other hand might also decrease objectivity-that are balanced out under moderate auditor rotation and regulatory controls. On the same note, the audit firm size (AuSize) shows a negative, although non-significant correlation with DAC ($r = -0.048$, $p = 0.450$). This is to indicate that high sized audit firms (Big Four affiliates) partially alleviate earnings management, however, their entire effect is also not strong, though, this is possibly because of the dominance of Big Four firms and the inconsistencies in the quality of local audit.

What is more, audit committee independence (ACInd) also offers a positive but non-significant correlation with DAC ($r = 0.035$, $p = 0.583$) which suggests that the independence of auditor committees is not enough to prevent earnings manipulation significantly. Although, in theory, independence of the audit committee increases the level of supervision, the observation implies the lack of practical implementation, the lack of expertise, or the token compliance among Sri Lankan companies.

Moving to the level of firm, firm size (SizeInAssets) demonstrates a positive and significant moderate relationship with DAC ($r = 0.384$, $p < 0.01$). Earnings management seems to be more common among larger firms, which may also be related to the fact that they have more freedom in the estimation of accruals and are under pressure to meet the expectations of the market. The leverage value is strongly and significantly correlated ($r = 0.783$, $p < 0.01$) thus the highly leveraged companies are more aggressive in earnings manipulation aiming to avoid debt covenant breach or to portray a better financial picture- as it is in agency theory. In the same way, operating cash flow (CFO) is also strongly related with DAC ($= 0.749$, $= 0.01$), which indicates that the more liquidity a firm has the more flexible it is to adjust accounting estimates in ways that are strategic, or managers use accruals to smooth earnings in cases where cash flows are volatile.
Return on assets (ROA) and DAC have the highest relationship, with a value of 0.899 ($p = 0.01$), indicating that the relationship between profit-making companies and higher discretionary accruals is observed. This can imply either that profitable companies are reporting inflated income in order to maintain the favorable trend of performance, or that accrual-based elements are just inherently elevated within successful companies.

Table 02: Correlation Coefficients

	AuTen	AuSize	AuInd	DAC	ACInd	SizeInAssets	Leverage	CFO	ROA	BoardSize	CEODual	BoardInd
AuTen	1	-.042	-.053	.031	-.319**	.051	-.026	.042	.062	.022	-.033	.092
AuSize	-.042	1	-.042	-.048	-.031	.028	-.076	.026	-.036	.016	.019	.111
AuInd	-.053	-.042	1	.579**	-.015	.470**	.662**	.545**	.519**	-.370**	-.275**	-.345**
DAC	.031	-.048	.579**	1	.035	.384**	.783**	.749**	.899**	-.224**	-.463**	-.072
ACInd	-.319**	-.031	-.015	.035	1	-.017	.012	.071	.043	.064	-.110	.122
SizeInAssets	.051	.028	.470**	.384**	-.017	1	.053	.752**	.469**	-.409**	.057	-.247**
Leverage	-.026	-.076	.662**	.783**	.012	.053	1	.388**	.700**	-.166**	-.369**	-.118
CFO	.042	.026	.545**	.749**	.071	.752**	.388**	1	.694**	-.348**	-.267**	-.083
ROA	.062	-.036	.519**	.899**	.043	.469**	.700**	.694**	1	-.080	-.250**	.067
BoardSize	.022	.016	-.370**	-.224**	.064	-.409**	-.166**	-.348**	-.080	1	.196**	.476**
CEODual	-.033	.019	-.275**	-.463**	-.110	.057	-.369**	-.267**	-.250**	.196**	1	-.138*
BoardInd	.092	.111	-.345**	-.072	.122	-.247**	-.118	-.083	.067	.476**	-.138*	1

**. Correlation is significant at the 0.01 level (2-tailed).

*. Correlation is significant at the 0.05 level (2-tailed).

In the case of corporate governance variables, the board size has moderate negative significant relationship with DAC (r = -0.224, p < 0.01), which contributes to the idea that bigger boards increase monitoring effectiveness and, therefore, restrict the manipulation of earnings. CEO duality exhibits a high negative and significant correlation (r = -0.463, p < 0.01), which means that dual leadership systems (in which the CEO also serves as a board chair) are being weakly related to reductions in earnings management. This is also contrary to the normal theory of governance but in this case of Sri Lanka this may represent founders-led firms where duality enhances the control and accountability as opposed to undermining the oversight. In the meantime, the relationship between board independence and EM is weak and insignificant (r = -0.072, p = 0.255), which can be interpreted to mean that independent directors are able to reduce EM marginally but do not have a strong effect probably because there is less enforcement or knowledge of complex accrual manipulation.

Lastly, some interrelations between independent variables indicate that there may be risks of multicollinearity, but they are analyzed later using regression diagnostics. It is interesting to note that leverage and ROA (r = 0.700, p < 0.01) have a high correlation, indicating that both are simultaneously related to the financial performance of firms. In the same manner, the firm size and the CFO (r = 0.752, p = -0.01) imply that large firms are more likely to generate more cash flows whereas auditor independence and leverage (r = 0.662, p = -0.01) implies that highly indebted firms will seek to hire more independent auditors to enhance their credibility with the stakeholders. On the whole, the findings indicate that the complex interactions exist where audit and governance mechanisms prove to be inconsistently effective in the limitation of earnings management, and financial factors specific to the firm (profitability, leverage, and cash flow) turn out to be stronger predictors of discretionary accrual behavior among Sri Lankan listed companies.

Table 06: Normality Analysis

	Kolmogorov-Smirnov			Shapiro-Wilk		
	Statistic	df	Sig.	Statistic	df	Sig.
AuTen	.423	250	.000	.598	250	.000
AuSize	.353	250	.000	.636	250	.000
AuInd	.086	250	.000	.981	250	.002
DAC	.047	250	.200*	.991	250	.135
ACInd	.194	250	.000	.873	250	.000
SizeInAssets	.077	250	.001	.985	250	.009
Leverage	.071	250	.004	.986	250	.015
CFO	.060	250	.031	.981	250	.002
ROA	.068	250	.007	.986	250	.014
BoardSize	.184	250	.000	.888	250	.000
CEODual	.433	250	.000	.588	250	.000
BoardInd	.166	250	.000	.908	250	.000

Normality Analysis

The Kolmogorov-Smirnov test and the Shapiro -Wilk test were used to test normalcy. Though most of the independent variables were not normally distributed ($p < 0.05$), the dependent variable (DAC) was normally distributed with acceptable normality levels ($p > 0.05$) as the Shapiro-Wilk test value is 0.135. As regression analysis presupposes the normality of residual values, and not an independent variable, this finding meets the condition of the validity of the linear regression.

Summary of Key Findings

The regression analysis offers important results on the effect of audit quality, corporate governance, and firm characteristics on the earnings management of Sri Lankan listed companies. On the factors of audit quality, the results show that the dimension of audit independence is the only key that minimizes the earnings management, which makes its critical importance to the maintenance of the objectivity and credibility of auditors. Conversely, audit tenure and audit firm size do not have significant effects, indicating that some of the mechanisms studied, namely the mandatory rotation of auditors and regulatory control, might be already in effect alleviating some of the threats to independence. With regards to the variables of corporate governance, independent board and audit committee have been observed to be effective in reducing earnings manipulation and therefore the significance of sound governance systems in improving transparency and oversight. Interestingly, the concept of CEO duality that is, the same person holding the position of CEO and board chair is related to less earnings management, which is contrary to the traditional governance theory. This might be due to the context-specific leadership in Sri Lanka whereby dual leadership can be more accountable than undermined. At the same time, the size of the board does not have much impact on the management of earnings, which means that the quality and experience of the board members are more important than the quantity. Lastly, with respect to the firm characteristics, the firm size depicts negative relationships with earnings management, which means that larger firms are more open and are under more scrutiny. On the other hand, leverage, return on assets (ROA) and operating cash flow (CFO) are significantly and positively correlated with earnings management implying that high leverage, well-performing firms with high cash flows have better chances to manipulate earnings in order to sustain desirable performance images. Generally, the findings highlight that audit independence and effective governance systems are the main discouraging factors of earnings manipulation, and financial stress and performance-related incentive remains an encouraging factor in discretionary reporting in Sri Lankan companies.

Discussion of Results

The findings of this research offer solid empirical support that the quality of audit is a serious limiting factor to the earnings management (EM) among listed non-financial companies in Sri Lanka. This observation is also consistent with the theoretical expectations of the agency theory, indicating that independent external auditors aid in alleviating agency issues by alleviating information asymmetry between shareholders and managers (Alzoubi, 2021). The authors

determined that the relationship between audit firm size and auditor independence on the one hand and EM on the other hand is statistically significant and negative meaning that firms that are audited by a large and reputable audit firm and those that exercise more independence on the part of the auditor have lower levels of discretionary accruals.

The bigger network-based audit firms, including the ones that are part of an international network, tend to be more technically proficient, more advanced with their audit procedures, and have more reputation to uphold the integrity of audits (Pakianathan, 2017). Therefore, these companies are not prone to allow the earnings to be significantly managed, which is aligned with previous cross-national results. This finding supports the thesis that quality audits are a control apparatus which safeguards the interests of shareholders and ensures financial transparency. Conversely, smaller local audit firms with few resources might not be able to identify such complicated manipulative accounting strategies and thus letting EM continue with (Perera and Amarasinghe, 2022).

The research also discovered that independence of the auditors is crucial in establishing effectiveness of the audit process. It was noted that firms that hire auditors who have high independence with the management were characterized by less EM. This is in line with the line of thinking of Withana and Ajward (2022) who implied that the independence of auditors is what allows them to be objective and unbiased and can identify and report irregularities without being affected by client relationships. Nevertheless, the corporate environment of Sri Lanka is challenging, and auditors tend to establish close and long-term relationships with clients because of such competition in the market. These relationships may pose a familiarity threat, which decreases independence with time, as is the same as in the case of audit tenure.

Findings on the audit tenure were more subtle. The moderate audit tenure was also identified to help in improving the quality of the audit as the auditors have a better understanding of the operations and the risks that the firm is exposed to and thus a better ability to detect irregularity. Nevertheless, independence may be compromised by excessive tenure by getting too familiar and complacent, which results in less diligent audit work. This two-fold effect confirms the claim of Taqi (2020) that extended auditor services can both enhance and jeopardize quality in audit in relation to the trade-off between accumulating knowledge and preserving independence.

In general, these results indicate that audit quality can be implemented as a powerful tool of minimizing opportunistic management practices and improving the reliability of the financial statements in the Sri Lankan context. The findings are in line with the previous worldwide literature but introduce new empirical data of an emerging market approach, where institutional and governance frameworks are yet to mature. Previous studies in Sri Lanka have been scant and description oriented and have not undertaken systematic study of the quantitative effect of the quality of audit on EM. This research thus offers a major research gap as it presents current evidence concerning research findings within the 2019-2023 period.

The implications of the findings to corporate governance and stability of the market are broad as well. Poor audit controls have been very popular in causing significant financial meltdowns in the history of Pramuka Bank and Golden Key PLC (Pakianathan et al., 2019). The findings of the research indicate that the audit quality, which is currently underpinned by the lack of independence, the lack of rotation requirement, and the nature of the professional standard, could be significantly improved to increase investor confidence and transparency in the Colombo Stock Exchange (CSE). This is especially essential in the post-Enron period when the world has put a higher focus on quality and accountability of audits (Perera and Amarasinghe, 2022).

Conclusions

The primary aim of the paper was to test the influence of audit quality on earnings management in listed non-financial companies in Sri Lanka in the period 2019-2023. Depending on the results, one can conclude that the quality of audits plays a great role in determining the level of earnings management. Particularly, compared to smaller audit firms and auditors that are highly independent, bigger audit firms and auditors are more effective in decreasing earnings manipulation, and the association between audit tenure and EM is ambivalent. These results confirm that an improved quality of audit increases the quality of financial reporting, stakeholder confidence, and decreases agency problems.

The findings also confirm the agency theory, as they justify that independent external audits are an important control tool that ensures that the interests of shareholders are not abused by managers who act out of opportunism (Alzoubi, 2021). This role is even greater in the Sri Lankan context where market regulation and the practices of market governance are still in their developmental stages. The research is an addition to the small range of existing empirical studies in Sri Lanka that would fill the gap to the past studies which concentrated more on developed economies. Essentially, this study highlights the fact that the quality of audit is one of the pillars of financial integrity. In the absence of quality audits, companies are likely to present falsified earnings more, and such activities undermine investor trust and may cause even larger scale economic instability. Thus, the issue of the enhancement of audit quality has to be the focus of the prioritized policy agenda of regulatory bodies, professional associations, and corporate governance frameworks in Sri Lanka.

Recommendations

It is recommended that based on the empirical findings and discussion a number of actionable recommendations are presented:
- Enhance auditor independence by regulation.

Stricter independence requirements, such as the requirement to change audit partners regularly and the requirement to disclose non-audit services offered to clients should be toughened by regulatory bodies, such as the Institute of Chartered Accountants of Sri Lanka (CA Sri Lanka) and the

Securities and Exchange Commission (SEC). This will ensure that familiarity threats and conflict of interest is reduced hence objective audit opinions.

- Promote participation in bigger or foreign related audit firms.

Professional standards should be encouraged by ensuring that listed companies hire big audit firms with more knowledge, resources, and reputational motivation to maintain professionalism. This may be better financial transparency and safeguard the investors, more so the high-risk sectors.

- Enhance ethical principles and professional training.

Audit firms ought to invest in lifelong professional learning especially forensic auditing, data analytics, and ethical decision-making. Ethical awareness is one of the factors that can minimize the chances of auditors being complicit in EM practices, and this is facilitated by continuous training.

- Improve corporate governance systems.

Business houses are encouraged to enhance the audit committees and include independent auditors with adequate financial literacy who can manage the external and internal audit functions. This will be accountable and enhance effectiveness of external audits.

- Enforcement and policy inclinations.

The penalties towards firms and auditors with financial misrepresentation should be made tougher by the regulators. Clear implementation and disclosure of audit deficiencies to the public would enhance accountability and prevent malpractice.

- Future research suggestions.

Further research is able to increase the data set to financial sponsors or experiment with other determinants like audit fees, industry specialization and change of audit partners. The qualitative information (interviews with the auditors and regulators) can also be used to enhance knowledge of the contextual issues in assuring the quality of audits in Sri Lanka.

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